

HAWTHORN BANCSHARES, INC.

Form 10-Q

August 14, 2017

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

*(Mark One)*

**x      Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended June 30, 2017

or

**..      Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: **0-23636**

**HAWTHORN BANCSHARES, INC.**

*(Exact name of registrant as specified in its charter)*

**Missouri**

**43-1626350**

*(State or other jurisdiction of      (I.R.S. Employer*

*incorporation or organization) Identification No.)*

132 East High Street, Box 688, Jefferson City, Missouri 65102

*(Address of principal executive offices)*

*(Zip Code)*

**(573) 761-6100**

(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **x** Yes " No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). **x** Yes " No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer "

Accelerated filer "

Non-accelerated filer **x** (Do not check if a smaller reporting company) Smaller reporting company "

Emerging growth company "

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. "

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

" Yes **x** No

As of August 4, 2017, the registrant had 5,831,210 shares of common stock, par value \$1.00 per share, outstanding



**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets** *(unaudited)**(In thousands, except per share data)*

|  | June 30,<br>2017 | December 31,<br>2016 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Cash and due from banks  | \$20,776         | \$ 25,589            |
| Federal funds sold and other overnight interest-bearing deposits                                 | 40,552           | 1,406                |
| Cash and cash equivalents  | 61,328           | 26,995               |
| Investment in available-for-sale securities, at fair value                                       | 216,353          | 214,512              |
| Other investments and securities, at cost  | 10,798           | 9,796                |
| Total investment securities  | 227,151          | 224,308              |
| Loans  | 1,035,020        | 974,029              |
| Allowances for loan losses   | (10,545 )        | (9,886 )             |
| Net loans  | 1,024,475        | 964,143              |
| Premises and equipment - net   | 35,403           | 35,522               |
| Mortgage servicing rights  | 2,766            | 2,584                |
| Other real estate and repossessed assets - net   | 13,356           | 14,162               |
| Accrued interest receivable  | 4,754            | 5,183                |
| Cash surrender value - life insurance  | 2,448            | 2,409                |
| Other assets   | 11,869           | 11,742               |
| Total assets   | \$1,383,550      | \$ 1,287,048         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                  |                      |
| <b>Deposits</b>  |                  |                      |
| Non-interest bearing demand  | \$279,634        | \$ 235,975           |
| Savings, interest checking and money market  | 517,678          | 468,731              |
| Time deposits \$250,000 and over   | 56,534           | 73,523               |
| Other time deposits  | 228,841          | 232,437              |
| Total deposits   | 1,082,687        | 1,010,666            |
| Federal funds purchased and securities sold under agreements to repurchase                       | 29,118           | 31,015               |
| Subordinated notes   | 49,486           | 93,392               |
| Federal Home Loan Bank advances  | 115,363          | 49,486               |
| Accrued interest payable   | 429              | 498                  |
| Other liabilities  | 11,320           | 10,974               |
| Total liabilities  | 1,288,403        | 1,196,031            |
| <b>Stockholders' equity:</b>   |                  |                      |
| Common stock, \$1 par value, authorized 15,000,000 shares; issued 5,822,357 shares, respectively | 5,822            | 5,822                |
| Surplus  | 45,665           | 41,498               |
| Retained earnings  | 50,796           | 51,671               |
| Accumulated other comprehensive loss, net of tax   | (2,874 )         | (3,801 )             |
| Treasury stock; 210,465 and 205,750 shares, at cost  | (4,262 )         | (4,173 )             |
| Total stockholders' equity   | 95,147           | 91,017               |
| Total liabilities and stockholders' equity   | \$1,383,550      | \$ 1,287,048         |

See accompanying notes to the consolidated financial statements (*unaudited*).

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Income** *(unaudited)*

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
| (In thousands, except per share amounts)  | 2017                           | 2016      | 2017                         | 2016      |
| <b>INTEREST INCOME</b>  |                                |           |                              |           |
| Interest and fees on loans  | \$ 11,671                      | \$ 10,308 | \$ 22,721                    | \$ 20,295 |
| Interest on investment securities:  |                                |           |                              |           |
| Taxable   | 737                            | 831       | 1,491                        | 1,769     |
| Nontaxable  | 168                            | 119       | 325                          | 262       |
| Federal funds sold and<br>other overnight interest-bearing deposits                       | 11                             | 17        | 60                           | 50        |
| Dividends on other securities   | 94                             | 75        | 184                          | 151       |
| Total interest income   | 12,681                         | 11,350    | 24,781                       | 22,527    |
| <b>INTEREST EXPENSE</b>   |                                |           |                              |           |
| Interest on deposits:   |                                |           |                              |           |
| Savings, interest checking and money market   | 475                            | 287       | 864                          | 582       |
| Time deposit accounts \$250,000 and over  | 99                             | 85        | 191                          | 153       |
| Other time deposits   | 410                            | 383       | 789                          | 764       |
| Interest on federal funds purchased and securities sold under agreements<br>to repurchase | 27                             | 15        | 49                           | 39        |
| Interest on subordinated notes  | 431                            | 366       | 840                          | 720       |
| Interest on Federal Home Loan Bank advances   | 419                            | 243       | 741                          | 450       |
| Total interest expense  | 1,861                          | 1,379     | 3,474                        | 2,708     |
| Net interest income   | 10,820                         | 9,971     | 21,307                       | 19,819    |
| Provision for loan losses   | 330                            | 425       | 680                          | 675       |
| Net interest income after provision for loan losses                                       | 10,490                         | 9,546     | 20,627                       | 19,144    |
| <b>NON-INTEREST INCOME</b>  |                                |           |                              |           |
| Service charges and other fees  | 851                            | 828       | 1,687                        | 1,662     |
| Bank card income and fees   | 663                            | 648       | 1,277                        | 1,282     |
| Trust department income   | 266                            | 265       | 540                          | 483       |
| Real estate servicing fees, net   | 34                             | (86 )     | 487                          | (32 )     |
| Gain on sale of mortgage loans, net   | 218                            | 222       | 374                          | 387       |
| Gain on sale of investment securities   | 0                              | 18        | 0                            | 490       |
| Other   | 67                             | 54        | 141                          | 125       |
| Total non-interest income   | 2,099                          | 1,949     | 4,506                        | 4,397     |
| <b>NON-INTEREST EXPENSE</b>   |                                |           |                              |           |
| Salaries and employee benefits  | 5,352                          | 5,305     | 10,806                       | 10,655    |
| Occupancy expense, net  | 689                            | 673       | 1,307                        | 1,306     |
| Furniture and equipment expense   | 634                            | 439       | 1,232                        | 850       |
| Processing, network, and bank card expense  | 927                            | 840       | 1,972                        | 1,611     |
| Legal, examination, and professional fees   | 317                            | 328       | 597                          | 662       |
| FDIC insurance assessment   | 115                            | 188       | 216                          | 364       |
| Advertising and promotion   | 265                            | 242       | 503                          | 452       |

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|                                      |         |         |         |         |
|--------------------------------------|---------|---------|---------|---------|
| Postage, printing, and supplies      | 263     | 291     | 495     | 527     |
| Real estate foreclosure expense, net | 226     | 42      | 253     | 183     |
| Other                                | 899     | 1,005   | 1,656   | 1,826   |
| Total non-interest expense           | 9,687   | 9,353   | 19,037  | 18,436  |
| Income before income taxes           | 2,902   | 2,142   | 6,096   | 5,105   |
| Income tax expense                   | 983     | 730     | 2,076   | 1,695   |
| Net income                           | 1,919   | 1,412   | 4,020   | 3,410   |
| Basic earnings per share             | \$ 0.33 | \$ 0.24 | \$ 0.69 | \$ 0.58 |
| Diluted earnings per share           | \$ 0.33 | \$ 0.24 | \$ 0.69 | \$ 0.58 |

See accompanying notes to the consolidated financial statements (*unaudited*).

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Comprehensive Income** *(unaudited)*

| <b>(In thousands)</b>  | Three Months Ended |          | Six Months Ended |          |
|--|--------------------|----------|------------------|----------|
|  | June 30,           |          | June 30,         |          |
|  | 2017               | 2016     | 2017             | 2016     |
| Net income   | \$ 1,919           | \$ 1,412 | \$ 4,020         | \$ 3,410 |
| Other comprehensive income, net of tax   |                    |          |                  |          |
| Investment securities available-for-sale:  |                    |          |                  |          |
| Unrealized gain on investment securities available-for-sale, net of tax              | 595                | 837      | 900              | 2,082    |
| Adjustment for gain on sale of investment securities, net of tax                     | 0                  | (11 )    | 0                | (304 )   |
| Defined benefit pension plans:   |                    |          |                  |          |
| Amortization of prior service cost included in net periodic pension cost, net of tax | 13                 | 12       | 27               | 24       |
| Total other comprehensive income   | 608                | 838      | 927              | 1,802    |
| Total comprehensive income   | \$ 2,527           | \$ 2,250 | \$ 4,947         | \$ 5,212 |

See accompanying notes to the consolidated financial statements *(unaudited)*.



**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Stockholders' Equity** *(unaudited)*

|                                       | Common   |          | Retained | Accumulated<br>Other<br>Comprehensive | Treasury    | Total<br>Stock -<br>holders' |
|---------------------------------------|----------|----------|----------|---------------------------------------|-------------|------------------------------|
| (In thousands)                        | Stock    | Surplus  | Earnings | Loss                                  | Stock       | Equity                       |
| Balance, December 31, 2015            | \$ 5,605 | \$38,549 | \$48,700 | \$ (2,018 )                           | \$ (3,550 ) | \$87,286                     |
| Net income                            | 0        | 0        | 3,410    | 0                                     | 0           | 3,410                        |
| Other comprehensive income            | 0        | 0        | 0        | 1,802                                 | 0           | 1,802                        |
| Stock based compensation expense      | 0        | 11       | 0        | 0                                     | 0           | 11                           |
| Purchase of treasury stock            | 0        | 0        | 0        | 0                                     | (226 )      | (226 )                       |
| Stock dividend                        | 0        | 3,149    | (3,149 ) | 0                                     | 0           | 0                            |
| Cash dividends declared, common stock | 0        | 0        | (542 )   | 0                                     | 0           | (542 )                       |
| Balance, June 30, 2016                | \$ 5,605 | \$41,709 | \$48,419 | \$ (216 )                             | \$ (3,776 ) | \$91,741                     |
| Balance, December 31, 2016            | \$ 5,822 | \$41,498 | \$51,671 | \$ (3,801 )                           | \$ (4,173 ) | \$91,017                     |
| Net income                            | 0        | 0        | 4,020    | 0                                     | 0           | 4,020                        |
| Other comprehensive income            | 0        | 0        | 0        | 927                                   | 0           | 927                          |
| Stock based compensation expense      | 0        | 2        | 0        | 0                                     | 0           | 2                            |
| Purchase of treasury stock            | 0        | 0        | 0        | 0                                     | (89 )       | (89 )                        |
| Stock dividend                        | 0        | 4,165    | (4,165 ) | 0                                     | 0           | 0                            |
| Cash dividends declared, common stock | 0        | 0        | (730 )   | 0                                     | 0           | (730 )                       |
| Balance, June 30, 2017                | \$ 5,822 | \$45,665 | \$50,796 | \$ (2,874 )                           | \$ (4,262 ) | \$95,147                     |

See accompanying notes to the consolidated financial statements *(unaudited)*.

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows** *(unaudited)*

|  | Six Months Ended June 30, |           |
|--|---------------------------|-----------|
|  | 2017                      | 2016      |
| <b>(In thousands)</b>  |                           |           |
| Cash flows from operating activities:  |                           |           |
| Net income   | \$ 4,020                  | \$ 3,410  |
| Adjustments to reconcile net income to net cash provided by operating activities:          |                           |           |
| Provision for loan losses  | 680                       | 675       |
| Depreciation expense   | 874                       | 962       |
| Net amortization of investment securities, premiums, and discounts                         | 828                       | 883       |
| Stock based compensation expense   | 2                         | 11        |
| Change in fair value of mortgage servicing rights  | (67 )                     | 453       |
| Gain on sale of investment securities  | 0                         | (490 )    |
| Loss (gain) on sales and dispositions of premises and equipment                            | 1                         | (6 )      |
| Gain on sales and dispositions of other real estate and repossessed assets                 | (38 )                     | (103 )    |
| Provision for other real estate owned  | 215                       | 76        |
| Decrease in accrued interest receivable  | 429                       | 227       |
| Increase in cash surrender value - life insurance  | (39 )                     | (31 )     |
| Increase in other assets   | (613 )                    | (715 )    |
| Decrease in accrued interest payable   | (69 )                     | (10 )     |
| Increase (decrease) in other liabilities   | 290                       | (546 )    |
| Origination of mortgage loans for sale   | (17,101 )                 | (17,017 ) |
| Proceeds from the sale of mortgage loans   | 16,861                    | 17,520    |
| Gain on sale of mortgage loans, net  | (374 )                    | (387 )    |
| Other, net   | (47 )                     | (79 )     |
| Net cash provided by operating activities  | 5,852                     | 4,833     |
| Cash flows from investing activities:  |                           |           |
| Net increase in loans  | (60,553 )                 | (59,499 ) |
| Purchase of available-for-sale debt securities   | (21,874 )                 | (76,417 ) |
| Proceeds from maturities of available-for-sale debt securities                             | 16,132                    | 24,457    |
| Proceeds from calls of available-for-sale debt securities                                  | 4,525                     | 10,035    |
| Proceeds from sales of available-for-sale debt securities                                  | 0                         | 44,300    |
| Proceeds from sales of FHLB stock  | 201                       | 0         |
| Purchases of FHLB stock  | (1,203 )                  | (1,003 )  |
| Purchases of premises and equipment  | (863 )                    | (592 )    |
| Proceeds from sales of premises and equipment  | 0                         | 6         |
| Proceeds from sales of other real estate and foreclosed assets                             | 784                       | 2,399     |
| Net cash used in investing activities  | (62,851 )                 | (56,314 ) |
| Cash flows from financing activities:  |                           |           |
| Net increase in demand deposits  | 43,659                    | 9,742     |
| Net increase in interest-bearing transaction accounts                                      | 48,947                    | 36,717    |
| Net (decrease) increase in time deposits   | (20,585 )                 | 11,585    |
| Net decrease in federal funds purchased and securities sold under agreements to repurchase | (2,389 )                  | (21,140 ) |
| Repayment of FHLB advances and other borrowings  | (130,277 )                | (8,000 )  |

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|  |           |           |
|--|-----------|-----------|
| FHLB advances                                  | 152,740   | 32,000    |
| Purchase of treasury stock                     | (89 )     | (226 )    |
| Cash dividends paid - common stock             | (674 )    | (542 )    |
| Net cash provided by financing activities      | 91,332    | 60,136    |
| Net increase in cash and cash equivalents      | 34,333    | 8,655     |
| Cash and cash equivalents, beginning of period | 26,995    | 28,377    |
| Cash and cash equivalents, end of period       | \$ 61,328 | \$ 37,032 |

See accompanying notes to the consolidated financial statements (*unaudited*).

**HAWTHORN BANCSHARES, INC. AND SUBSIDIARIES**  
**Consolidated Statements of Cash Flows (continued)** *(unaudited)*

| <b>(In thousands)</b>  | Six Months Ended June 30, |          |
|--|---------------------------|----------|
|  | 2017                      | 2016     |
| Supplemental disclosures of cash flow information:                       |                           |          |
| Cash paid during the year for:   |                           |          |
| Interest   | \$ 3,542                  | \$ 2,718 |
| Income taxes   | \$ 2,185                  | \$ 1,975 |
| Noncash investing activities:  |                           |          |
| Other real estate and repossessed assets acquired in settlement of loans | \$ 155                    | \$ 1,634 |

See accompanying notes to the consolidated financial statements *(unaudited)*.

Hawthorn Bancshares, Inc.  
and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

(1) Summary of Significant Accounting Policies

Hawthorn Bancshares, Inc. (the Company) through its subsidiary, Hawthorn Bank (the Bank), provides a broad range of banking services to individual and corporate customers located within the communities in and surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, Branson, and the greater Kansas City metropolitan area. The Company is subject to competition from other financial and nonfinancial institutions providing financial products. Additionally, the Company and its subsidiaries are subject to the regulations of certain regulatory agencies and undergo periodic examinations by those regulatory agencies.

The accompanying unaudited consolidated financial statements of the Company have been prepared in conformity with U.S. generally accepted accounting principles (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X. Accordingly, the unaudited consolidated financial statements do not include all of the information and disclosures required by U.S. GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

The preparation of the consolidated financial statements includes all adjustments that, in the opinion of management, are necessary in order to make those statements not misleading. Management is required to make estimates and assumptions, including the determination of the allowance for loan losses, real estate acquired in connection with foreclosure or in satisfaction of loans, and fair values of investment securities available-for-sale that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company's management has evaluated and did not identify any subsequent events or transactions requiring recognition or disclosure in the consolidated financial statements.

**Stock Dividend** On July 1, 2017, the Company paid a special stock dividend of four percent to shareholders of record at the close of business on June 15, 2017. For all periods presented, share information, including basic and diluted

earnings per share, has been adjusted retroactively to reflect this change.

**The following represents significant new accounting principles adopted in 2017:**

***Stock Compensation*** The FASB issued ASU 2016-09, *Improvements to Employee Share-Based Payment Accounting*, in March 2016, in order to reduce complexity in this area and improve the usefulness of information provided to users. Amendments which will affect public companies include the recognition of excess tax benefits and deficiencies in income tax expense or benefit in the income statement, guidance as to the classification of excess tax benefits on the statement of cash flows, an election to account for award forfeitures as they occur, and the ability to withhold taxes up to the maximum statutory rate in the applicable jurisdictions without triggering liability classification of the award. The Company adopted the ASU on January 1, 2017 and elected to recognize forfeitures as they occur. As allowed by the ASU, the Company's adoption was prospective, therefore prior periods have not been adjusted. The adoption of the ASU could result in increased volatility to reported income tax expense related to excess tax benefits and tax deficiencies for employee share-based transactions, however, the actual amounts recognized in income tax expense will be dependent on the amount of employee share-based transactions and the stock price at the time of vesting or exercise. The adoption of the ASU did not have a significant effect on the Company's consolidated financial statements.

Hawthorn Bancshares, Inc.  
and subsidiaries

Notes to the Consolidated Financial Statements

*(Unaudited)*

(2) Loans and Allowance for Loan Losses

*Loans*

A summary of loans, by major class within the Company's loan portfolio, at June 30, 2017 and December 31, 2016 is as follows:

| <b>(in thousands)</b>                   | <b>June 30,<br/>2017</b> | <b>December 31,<br/>2016</b> |
|---|--------------------------|------------------------------|
| Commercial, financial, and agricultural | \$187,251                | \$ 182,881                   |
| Real estate construction - residential  | 20,037                   | 18,907                       |
| Real estate construction - commercial   | 78,257                   | 55,653                       |
| Real estate mortgage - residential      | 255,426                  | 259,900                      |
| Real estate mortgage - commercial       | 461,062                  | 426,470                      |
| Installment and other consumer          | 32,987                   | 30,218                       |
| Total loans                             | \$1,035,020              | \$ 974,029                   |

The Bank grants real estate, commercial, installment, and other consumer loans to customers located within the communities surrounding Jefferson City, Columbia, Clinton, Warsaw, Springfield, Branson and the greater Kansas City metropolitan area. As such, the Bank is susceptible to changes in the economic environment in these communities. The Bank does not have a concentration of credit in any one economic sector. Installment and other consumer loans consist primarily of the financing of automotive vehicles. At June 30, 2017, \$496.0 million of loans were pledged to the Federal Home Loan Bank as collateral for borrowings and letters of credit.

*Allowance for Loan Losses*

The following is a summary of the allowance for loan losses during the periods indicated.

| Three Months Ended June 30, 2017  |                           |  |                                       |                                    |                                   |                                |             |          |
|-----------------------------------|---------------------------|--|---------------------------------------|------------------------------------|-----------------------------------|--------------------------------|-------------|----------|
| (in thousands)                    | Commercial & Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment and Other Consumer | Unallocated | Total    |
|                                   |                           |  |                                       |                                    |                                   |                                |             |          |
| Balance at beginning of period    | \$2,360                   | \$ 99                                  | \$ 579                                | \$ 2,125                           | \$ 4,731                          | \$ 322                         | \$ 46       | \$10,262 |
| Additions:                        |                           |  |                                       |                                    |                                   |                                |             |          |
| Provision for loan losses         | 226                       | (54 )                                  | 36                                    | (230 )                             | 139                               | 89                             | 124         | 330      |
| Deductions:                       |                           |  |                                       |                                    |                                   |                                |             |          |
| Loans charged off                 | 32                        | 0                                      | 0                                     | 62                                 | 2                                 | 60                             | 0           | 156      |
| Less recoveries on loans          | (24 )                     | (25 )                                  | 0                                     | (21 )                              | (14 )                             | (25 )                          | 0           | (109 )   |
| Net loan charge-offs (recoveries) | 8                         | (25 )                                  | 0                                     | 41                                 | (12 )                             | 35                             | 0           | 47       |
| Balance at end of period          | \$2,578                   | \$ 70                                  | \$ 615                                | \$ 1,854                           | \$ 4,882                          | \$ 376                         | \$ 170      | \$10,545 |
| Six Months Ended June 30, 2017    |                           |  |                                       |                                    |                                   |                                |             |          |
| (in thousands)                    | Commercial & Agricultural | Real Estate Construction - Residential | Real Estate Construction - Commercial | Real Estate Mortgage - Residential | Real Estate Mortgage - Commercial | Installment and Other Consumer | Unallocated | Total    |
|                                   |                           |  |                                       |                                    |                                   |                                |             |          |
| Balance at beginning of period    | \$2,753                   | \$ 108                                 | \$ 413                                | \$ 2,385                           | \$ 3,793                          | 274                            | \$ 160      | \$9,886  |
| Additions:                        |                           |  |                                       |                                    |                                   |                                |             |          |
| Provision for loan losses         | (157 )                    | (113 )                                 | 202                                   | (507 )                             | 1,084                             | 161                            | 10          | 680      |
| Deductions:                       |                           |  |                                       |                                    |                                   |                                |             |          |
| Loans charged off                 | 60                        | 0                                      | 0                                     | 81                                 | 16                                | 111                            | 0           | 268      |
| Less recoveries on loans          | (42 )                     | (75 )                                  | 0                                     | (57 )                              | (21 )                             | (52 )                          | 0           | (247 )   |
| Net loan charge-offs (recoveries) | 18                        | (75 )                                  | 0                                     | 24                                 | (5 )                              | 59                             | 0           | 21       |
| Balance at end of period          | \$2,578                   | \$ 70                                  | \$ 615                                | \$ 1,854                           | \$ 4,882                          | \$ 376                         | \$ 170      | \$10,545 |



Hawthorn Bancshares, Inc.  
and subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

|                                   | Three Months Ended June 30, 2016 |  |   |  |                                       |   |                  |         |
|-----------------------------------|----------------------------------|--|---|--|---------------------------------------|---|------------------|---------|
|                                   | Commercial<br>& Agricultural     | Real Estate<br>Construction<br>Residential | Real Estate<br>Construction<br>Commercial | Real Estate<br>Mortgage<br>Residential | Real Estate<br>Mortgage<br>Commercial | Installment<br>and<br>Other<br>Consumer | Un-<br>allocated | Total   |
| <b>(in thousands)</b>             |                                  |  |   |  |                                       |   |                  |         |
| Balance at beginning of period    | \$2,135                          | \$ 44                                      | \$ 687                                    | \$ 2,273                               | \$ 3,190                              | \$ 259                                  | \$ 43            | \$8,631 |
| Additions:                        |                                  |  |   |  |                                       |   |                  |         |
| Provision for loan losses         | 817                              | 19   | (929 )                                    | 186                                    | 218                                   | 61                                      | 53               | 425     |
| Deductions:                       |                                  |  |   |  |                                       |   |                  |         |
| Loans charged off                 | 36                               | 0  | 0   | 175                                    | 28                                    | 67                                      | 0                | 306     |
| Less recoveries on loans          | (80 )                            | 0  | (491 )                                    | (9 )                                   | (31 )                                 | (31 )                                   | 0                | (642 )  |
| Net loan charge-offs (recoveries) | (44 )                            | 0  | (491 )                                    | 166                                    | (3 )                                  | 36                                      | 0                | (336 )  |
| Balance at end of period          | \$2,996                          | \$ 63                                      | \$ 249                                    | \$ 2,293                               | \$ 3,411                              | \$ 284                                  | \$ 96            | \$9,392 |
|                                   |                                  |  |   |  |                                       |   |                  |         |
|                                   | Six Months Ended June 30, 2016   |  |   |  |                                       |   |                  |         |
|                                   | Commercial<br>& Agricultural     | Real Estate<br>Construction<br>Residential | Real Estate<br>Construction<br>Commercial | Real Estate<br>Mortgage<br>Residential | Real Estate<br>Mortgage<br>Commercial | Installment<br>and<br>Other<br>Consumer | Un-<br>allocated | Total   |
| <b>(in thousands)</b>             |                                  |  |   |  |                                       |   |                  |         |
| Balance at beginning of period    | \$2,153                          | \$ 59                                      | \$ 644                                    | \$ 2,439                               | \$ 2,935                              | \$ 273                                  | \$ 101           | \$8,604 |
| Additions:                        |                                  |  |   |  |                                       |   |                  |         |
| Provision for loan losses         | 804                              | 4  | (896 )                                    | 218                                    | 495                                   | 55                                      | (5 )             | 675     |
| Deductions:                       |                                  |  |   |  |                                       |   |                  |         |
| Loans charged off                 | 138                              | 0  | 1   | 381                                    | 111                                   | 123                                     | 0                | 754     |
| Less recoveries on loans          | (177 )                           | 0  | (502 )                                    | (17 )                                  | (92 )                                 | (79 )                                   | 0                | (867 )  |
| Net loan charge-offs (recoveries) | (39 )                            | 0  | (501 )                                    | 364                                    | 19                                    | 44                                      | 0                | (113 )  |
| Balance at end of period          | \$2,996                          | \$ 63                                      | \$ 249                                    | \$ 2,293                               | \$ 3,411                              | \$ 284                                  | \$ 96            | \$9,392 |

Loans, or portions of loans, are charged off to the extent deemed uncollectible or a loss is confirmed. Loan charge-offs reduce the allowance for loan losses, and recoveries of loans previously charged off are added back to the allowance. If management determines that it is probable that all amounts due on a loan will not be collected under the original terms of the loan agreement, the loan is considered to be impaired. These loans are evaluated individually for impairment, and in conjunction with current economic conditions and loss experience, specific reserves are estimated as further discussed below. Loans not individually evaluated are aggregated by risk characteristics and reserves are recorded using a consistent methodology that considers historical loan loss experience by loan type, delinquencies, current economic conditions, loan risk ratings and industry concentration.

Beginning in the first quarter of 2016, the Company began to lengthen its look-back period with the intent to increase such period from three to five years over the next two years. The Company believes that the five-year look-back period, which is consistent with the Company's practices prior to the start of the economic recession in 2008, provides a representative historical loss period in the current economic environment.

The following table provides the balance in the allowance for loan losses at June 30, 2017 and December 31, 2016, and the related loan balance by impairment methodology.

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(Unaudited)

|                                       | Commercial,<br>Financial,<br>and<br>Agricultural | Real<br>Estate<br>Construction<br>Residential | Real<br>Estate<br>Construction<br>Commercial | Real<br>Estate<br>Mortgage<br>Residential | Real<br>Estate<br>Mortgage<br>Commercial | Installment<br>and<br>Other<br>Consumer | Un-<br>allocated | Total        |
|---------------------------------------|--|---|--|---|--|---|------------------|--------------|
| <b>(in thousands)</b>                 |  |   |  |   |  |   |                  |              |
| June 30, 2017                         |  |   |  |   |  |   |                  |              |
| Allowance for loan losses:            |  |   |  |   |  |   |                  |              |
| Individually evaluated for impairment | \$ 393   | \$ 0  | \$ 7   | \$ 450                                    | \$ 264                                   | \$ 11                                   | \$ 0             | \$ 1,125     |
| Collectively evaluated for impairment | 2,185  | 70  | 608  | 1,404                                     | 4,618                                    | 365                                     | 170              | 9,420        |
| Total                                 | \$ 2,578   | \$ 70   | \$ 615                                       | \$ 1,854                                  | \$ 4,882                                 | \$ 376                                  | \$ 170           | \$ 10,545    |
| Loans outstanding:                    |  |   |  |   |  |   |                  |              |
| Individually evaluated for impairment | \$ 1,787   | \$ 0  | \$ 48  | \$ 5,787                                  | \$ 2,046                                 | \$ 52                                   | \$ 0             | \$ 9,720     |
| Collectively evaluated for impairment | 185,464  | 20,037  | 78,209                                       | 249,639                                   | 459,016                                  | 32,935                                  | 0                | 1,025,300    |
| Total                                 | \$ 187,251                                       | \$ 20,037                                     | \$ 78,257                                    | \$ 255,426                                | \$ 461,062                               | \$ 32,987                               | \$ 0             | \$ 1,035,020 |
| December 31, 2016                     |  |   |  |   |  |   |                  |              |
| Allowance for loan losses:            |  |   |  |   |  |   |                  |              |
| Individually evaluated for impairment | \$ 469   | \$ 0  | \$ 7   | \$ 319                                    | \$ 277                                   | \$ 8                                    | \$ 0             | \$ 1,080     |
| Collectively evaluated for impairment | 2,284  | 108   | 406  | 2,066                                     | 3,516                                    | 266                                     | 160              | 8,806        |
| Total                                 | \$ 2,753   | \$ 108  | \$ 413                                       | \$ 2,385                                  | \$ 3,793                                 | \$ 274                                  | \$ 160           | \$ 9,886     |

## Loans outstanding:

|   |            |           |           |            |            |           |      |            |
|---|------------|-----------|-----------|------------|------------|-----------|------|------------|
| Individually<br>evaluated for<br>impairment | \$ 1,617   | \$ 0      | \$ 49     | \$ 5,471   | \$ 1,918   | \$ 89     | \$ 0 | \$ 9,144   |
| Collectively<br>evaluated for<br>impairment | 181,264    | 18,907    | 55,604    | 254,429    | 424,552    | 30,129    | 0    | 964,885    |
| Total                                       | \$ 182,881 | \$ 18,907 | \$ 55,653 | \$ 259,900 | \$ 426,470 | \$ 30,218 | \$ 0 | \$ 974,029 |

*Impaired Loans*

Loans evaluated under ASC 310-10-35 include loans which are individually evaluated for impairment. All other loans are collectively evaluated for impairment under ASC 450-20. Impaired loans individually evaluated for impairment totaled \$9.7 million and \$9.1 million at June 30, 2017 and December 31, 2016, respectively, and are comprised of loans on non-accrual status and loans which have been classified as troubled debt restructurings (TDRs).

The net carrying value of impaired loans is based on the fair values of collateral obtained through independent appraisals or internal evaluations, or by discounting the total expected future cash flows. At June 30, 2017 and December 31, 2016, \$5.7 million and \$4.5 million, respectively, of impaired loans were evaluated based on the fair value less estimated selling costs of the loan's collateral. Once the impairment amount is calculated, a specific reserve allocation is recorded. At June 30, 2017, \$1.1 million of the Company's allowance for loan losses was allocated to impaired loans totaling \$9.7 million compared to \$1.1 million of the Company's allowance for loan losses allocated to impaired loans totaling approximately \$9.1 million at December 31, 2016. Management determined that \$1.7 million, or 18%, of total impaired loans required no reserve allocation at June 30, 2017 compared to \$2.1 million, or 23%, at December 31, 2016 primarily due to adequate collateral values, acceptable payment history and adequate cash flow ability.

The categories of impaired loans at June 30, 2017 and December 31, 2016 are as follows:

|                       | June 30,<br>2017 | December 31,<br>2016 |
|-----------------------|------------------|----------------------|
| <b>(in thousands)</b> |                  |                      |
| Non-accrual loans     | \$ 4,434         | \$ 3,429             |
| Performing TDRs       | 5,286            | 5,715                |
| Total impaired loans  | \$ 9,720         | \$ 9,144             |

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The following tables provide additional information about impaired loans at June 30, 2017 and December 31, 2016, respectively, segregated between loans for which an allowance has been provided and loans for which no allowance has been provided.

|                       | Recorded   | Unpaid    | Specific |
|-----------------------|------------|-----------|----------|
|                       | Investment | Principal | Reserves |
| <b>(in thousands)</b> |            |           |          |
| June 30, 2017         |            |           |          |